

HOUSE BUDGET COMMITTEE

Democratic Caucus

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ANALYSIS OF OMB MID-SESSION REVIEW

There are two major causes for concern in the Administration's summer update. First, *the Administration adopts a number of questionable assumptions* and thus produces numbers that are implausibly optimistic. In all likelihood, the true budget picture is even worse than reported in the Mid-Session Review. Second, even taken at face value, *the Administration budget calls for substantial on-budget deficits and thus gives up on its previous promise to protect the Social Security surplus. The Mid-Session Review calls for spending \$1.97 trillion of the Social Security Trust Fund surplus from 2002 to 2011.*

Despite the Administration's claims to the contrary, this dramatic deterioration of the budget picture cannot be primarily attributed to the effects of September 11 and the recession. Spending for the war on terrorism accounts for only 12 percent of the ten-year budget decline, while the Mid-Session Review assumes GDP that will be between \$130 billion and \$240 billion per year higher than that assumed in the President's budget five months ago.

The Administration's Report

- **Ten-Year Picture** — The Administration's summer update shows only a modest \$175 billion downward revision over ten years relative to its February 2002 projection. The 2002-11 unified surplus has declined from the \$5.6 trillion surplus estimate in February 2001 to a \$444 billion post-policy surplus today. The on-budget accounts (that is, excluding Social Security) for 2002-11 have deteriorated from a baseline surplus of \$3.0 trillion in February 2001 to a \$1.97 trillion deficit for the same period. Thus,

From Surplus to Deficit in Non-Social Security Budget

Trillions of Dollars

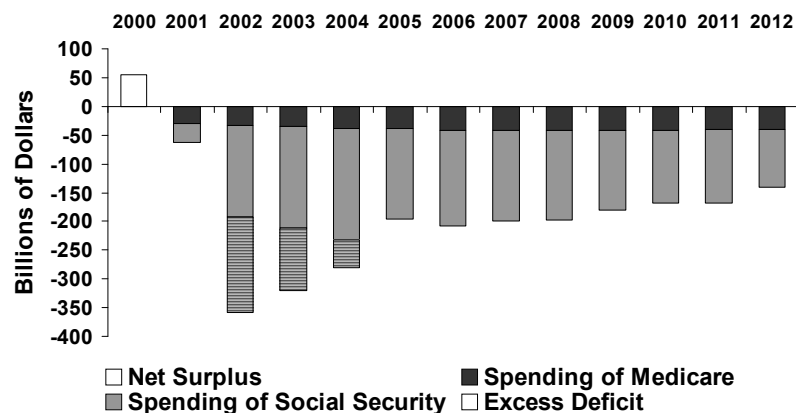
	2002-2011
April 2001	3.046
August 2001	0.575
February 2002	-1.650
July 2002	-1.968

Source: Office of Management and Budget

the Mid-Session Review continues to show an Administration budget that chronically spends the Social Security surplus.

- Year-By-Year Picture** — The Administration projects a unified deficit for 2002 of \$165 billion, revised downward from their February projection of \$106 billion. The Administration claims that the deficit will shrink from \$165 billion in 2002 to \$109 billion in 2003. (By contrast, the Senate Budget Committee Republican staff estimates that the 2003 deficit will increase to \$194 billion.) The Administration asserts that in 2005 the budget will achieve a small surplus (\$53 billion), with growing surpluses thereafter. However, in no year covered by these projections does the Administration project that unified surpluses will be as large as the Social Security surplus, meaning that the Administration's budget will continue to spend the Social Security surplus in every year covered by these projections.

President's Budget Spends Social Security and Medicare



The Administration's Numbers Are Implausibly Optimistic

The small \$175 billion ten-year OMB downward revision of the budget outlook is simply not credible, in light of April's revenue collapse and the recent state of the stock market. OMB's rosy outlook results from a variety of questionable assumptions. (The Administration has made only minor changes in its policy prescriptions.) The overly optimistic economic and technical assumptions mask the true extent of the likely deterioration in the budget outlook. The most notable examples of questionable assumptions that make projected deficits look smaller and projected surpluses look larger are the following:

Economic Assumptions

- Overall Income Tax Receipts** — OMB claims to have provided cautious new revenue estimates, in light of the enormous drag in FY2002 income tax receipts. However, their new numbers are still rosy. Absent the enacted and proposed tax cuts, OMB's projected individual income tax revenues for 2007 are projected to have zoomed right back up to the record level of FY2000. Since the President submitted his budget in February, revenues have collapsed, and the stock market has declined. Yet, the Administration

assumes that revenues will increase by nearly 9 percent in 2003 and by almost as much in 2004 and 2005. The budget further predicts that total revenues in 2006 through 2012 will be greater than assumed in the President's February budget.

- **Taxable Share of GDP** — In last year's Mid-Session Review, OMB predicted that the taxable portion of GDP will decline over the next decade. CBO's projections have been consistent with this view; this trend results from the assumption that rising health care costs will drive up the portion of income that is not taxed over time. However, this year's Mid-Session Review reverses course, predicting now that the taxable portion of GDP will rise rather sharply between now and 2005 before trending down from that higher level. This means that for most of the ten-year period, OMB is now assuming that the taxable portion of GDP will be hundreds of billions higher than OMB assumed just a year ago.
- **Tax Revenues from Capital Gains** — On Friday OMB Director Mitch Daniels stated that the Administration's projection assumes that tax revenues from capital gains will increase, albeit slowly, from their current level. However, this assumption seems at odds with the facts: capital gains tax receipts next April will be determined by capital gains realizations this calendar year, and the average for the S&P 500 thus far this year is down about 10 percent from its 2001 average.
- **Jump in Corporate Profits** — The Mid-Session Review asserts that the unified deficit will grow smaller in 2003 and will reach balance in 2005. The Mid-Session Review also assumes that corporate profits will jump by more than 20 percent in 2003 and by more than 25 percent in 2005. In the last half century, there have been only three years when corporate profits have jumped by more than 25 percent and only six years when they increased by more than 20 percent.

Understated Costs

- **Medicare Baseline** — The Mid-Session Review ten-year baseline projections for Medicare spending continue to be lower than CBO's baseline projections. The Mid-Session Review projections show some increase in baseline Medicare spending but are still \$173 billion below CBO's March 2002 projections for the same period.
- **Understated Prescription Drug Costs** — The Mid-Session Review bases its numbers on a figure of \$190 billion for Medicare prescription drugs, despite the Administration endorsement of the \$350 billion bill passed by House Republicans.
- **Unrealistic Cuts to Discretionary Spending** — At first glance, the Mid-Session Review shows appropriations outside of Defense and Homeland Security growing by 2 percent from 2002 to 2003. However, a true picture of domestic appropriations requires subtracting international affairs spending and adding the transportation obligation limitations provided by the Appropriations Committee. When these numbers are included, it is apparent that the Administration arrives at its apparently smaller deficit number for 2003 only by assuming a nominal cut of 0.4 percent in domestic

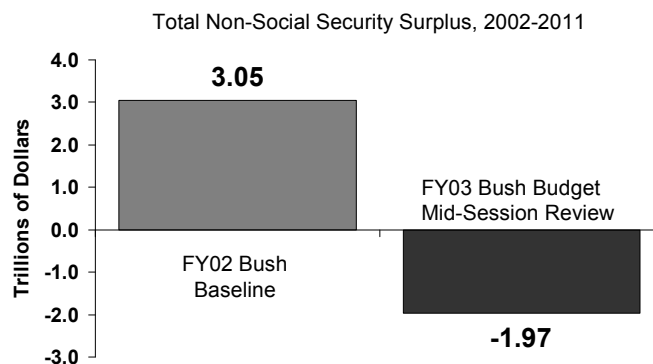
appropriations. In light of the President's proposals for increases in foreign assistance, education, health research, and the SEC, such a cut in total domestic spending is not plausible.

- **Other Omitted Costs** — The Mid-Session Review does not include the cost of numerous other items, including: a fix for the Alternative Minimum Tax (AMT); the Administration's February proposal to make permanent the three-year bonus depreciation contained in the stimulus bill; an extension of popular tax provisions due to expire in the next few years; the roughly \$1 trillion needed to fund the transition costs of the President's proposal to privatize Social Security; the cost of natural disasters; and the roughly \$30 billion cost of the President's Millennium Challenge Account foreign assistance proposal.

The Administration's Budget Has Given Up on Protecting Social Security

- **By Administration's Own Numbers, \$1.97 Trillion Spent from Social Security Surplus** — Last year, the President and House Republican leaders reaffirmed their promise to protect every penny of the Social Security Trust Fund surplus. Indeed, last year's Mid-Session Review highlighted this pledge by placing it on page 1 and page 2 of the report. One year later, the report contains no discussion of this promise. The numbers contained in the update reveal why. Even taken at face value, the Administration's budget shows a chronic invasion of the Social Security Trust Fund. The Social Security Trust Fund surplus is more than consumed by on-budget deficits through 2004, and it is partially consumed throughout the ten-year projection. The Administration's budget, taken at face value, consumes \$1.97 trillion of the Social Security Trust Fund surplus from 2002-11.

Republicans Spend the Social Security Surplus



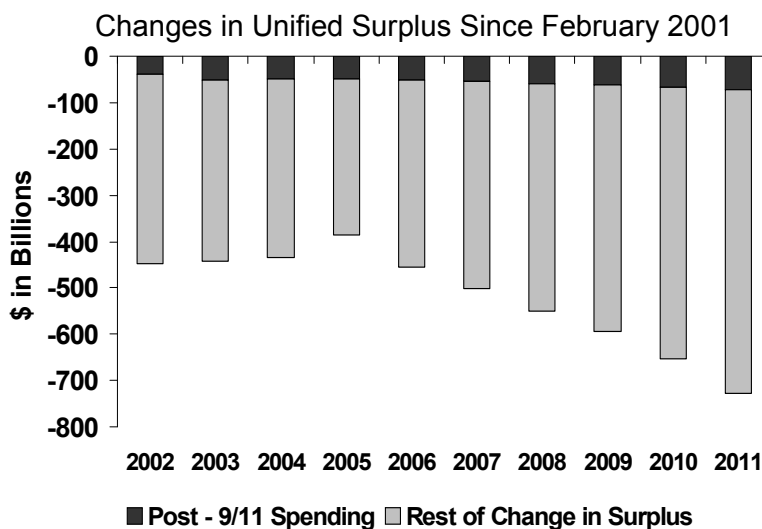
- **Administration Chooses More Tax Cuts Over Protecting Social Security** — Despite the clear deterioration of the budget picture since February 2001, the Administration continues to push for additional tax cuts, even though these tax cuts mean deeper invasions of the Social Security Trust Fund. Indeed, this Mid-Session Review proposes over \$500 billion in new tax cuts over ten years.
- **True Picture Likely to Be Much Worse** — As discussed in the previous section, there are numerous reasons to suggest that the Administration's budget outlook is overly

optimistic. A more realistic projection of the items noted above would likely show an Administration budget with worse deficits and deeper spending of the Social Security surplus.

September 11 and Recession are not the Primary Cause of the Budget Deterioration

- September 11 About One-Third the Impact of the Tax Cut** — When the Administration assumed office, the unified surplus over the 2002 - 2011 period was \$5.6 trillion. OMB now estimates it to be \$444 billion, a decrease of \$5.2 trillion. As discussed in detail below, the broadest reasonable definition of the total cost of September 11 would reach about \$600 billion, including interest. In comparison, the 2002-2011 cost of the enacted Bush tax cut, including interest, is \$1.5 trillion according to OMB's latest estimate (and the President now proposes another \$541 billion of tax cuts, not including interest, over 2003-2012). While significant, the total incurred and projected cost of September 11 pales in comparison to the Bush tax cuts. September 11 accounts for less than 12 percent of the total deterioration of the surplus, while the enacted tax cut alone accounts for 29 percent.

Gauging the Impact of September 11:



- The Cost of September 11 Is Approximately \$600 Billion** — The cost of September 11 includes the \$40 billion emergency spending bill enacted in the aftermath, the airline bailout bill, the USA PATRIOT Act, and the victims compensation bill. It also assumes enactment of the 2002 supplemental; the doubling of homeland security funding above pre-September 11 levels; establishment of the Department of Homeland Security (H.R. 5005); and the Pentagon's cost of conducting the war on terrorism at more than \$20 billion per year. This last assumption could easily prove overly pessimistic, as operations in Afghanistan are already slowing. If so, the ultimate cost would come in lower. These costs are detailed (outlays only) in the attached table and include interest costs as well.
- The Problem is Not the Recession** — The Administration also argues that the impact of

the recession is larger than that of the tax cut. However, the numbers indicate the contrary. In its own February FY 2003 *Budget* (table S-16, page 415) and the accompanying *Analytical Perspectives* volume (table 2-4, page 28), OMB showed that the tax cut was the largest single cause of the deterioration, accounting for 43 percent of the total change over the ten years 2002-2011. The economy contributed only 30 percent of the total change; legislation other than the tax cut contributed 17 percent; and technical estimating factors (such as the effect of the stock market on tax collections) contributed 10 percent.

Since that time, the economy has performed better than the Administration had assumed (with the recession ending sooner than expected, and with the recovery stronger than projected), making it inconceivable that the cost due to the recession could now surpass that of the tax cut. OMB's current claims regarding the impact of the economy are based on the combined costs of economic factors and technical estimating factors, which is contrary to the measurement practice of all other recent administrations. (This Administration has chosen to combine those two factors in its numerical tables in the *Mid-Session Review*, to hide the true breakdown of the costs.)